ATLANTIC PROVINCES ECONOMIC COUNCIL

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Report Card

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Fiscal Challenges in the Atlantic Provinces

The Atlantic provinces are in the midst of a sharp reversal in their fiscal fortunes with deficits in all four provinces pushing public debt up rapidly. The recession has caused a sharp slowdown in revenue growth, deepened by a decline in resource revenues due to falling commodity prices. Meanwhile, program spending continues to grow. With public infrastructure spending to help stimulate the economy also adding to borrowing requirements, provincial debt in the Atlantic region will expand by between 9% and 14% in 2009/2010.

It's certainly not all doom and gloom. The current provincial deficits are smaller relative to the size of their economies than during the two previous recessions. Provincial governments also have a greater ability to bear more debt because their net debt-to-GDP ratios were lower in 2008/2009 than in the late 1990s. However, the net debt-to-GDP ratio is expected to rise in all four provinces in 2009/2010.

The Need for Action

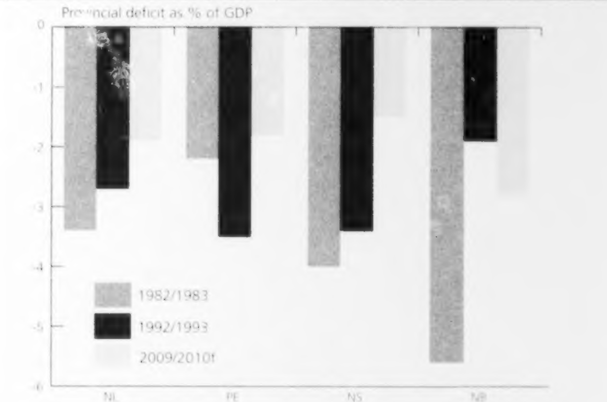
Newfoundland and Labrador is best positioned to realign expenditures with revenues. Resource revenues have helped the province move from being the most indebted province in 1998/1999, with a debt-to-GDP ratio of over 70%, to the province with the fifth-lowest debt-to-GDP ratio ten years later. Offshore royalties are expected to average well over $2 billion per year over the next ten years, helped by improving oil prices and recent royalty agreements relating to new or expanded projects. Nevertheless, with offshore royalties accounting for 37% of total revenues in 2008/2009, the province is heavily exposed to fluctuations in oil output and global oil prices.

The Maritime provinces are less advantaged, with a structural deficit in the making, meaning the deficit may not be automatically eliminated as the economy recovers. An independent Economic Advisory Panel in Nova Scotia concluded last fall that the province "is on an unsustainable fiscal path" and is facing a "substantial structural deficit". Without remedial policy, the deficit in Nova Scotia is currently forecast to reach $1.4 billion by 2012/2013.

New Brunswick's deficit in 2009/1010 is the second-largest in Canada, relative to the size of its economy. The deficit has been swollen by its *Plan to Lower Taxes* which will remove $1 billion from provincial revenues over the next four years. The government now expects the deficit will be erased by 2014/2015, two years later than initially forecast. To achieve balance, the government projects that total expenses will be trimmed by 0.8% in 2011/2012 and will then grow at about 0.6% for the next three fiscal years. However, no details have been provided on how these spending targets will be met. Expenditure growth has averaged 6.5% annually over the last five years. If spending continues to grow at this rate the deficit could balloon to $1.5-2.0 billion by 2014/2015.

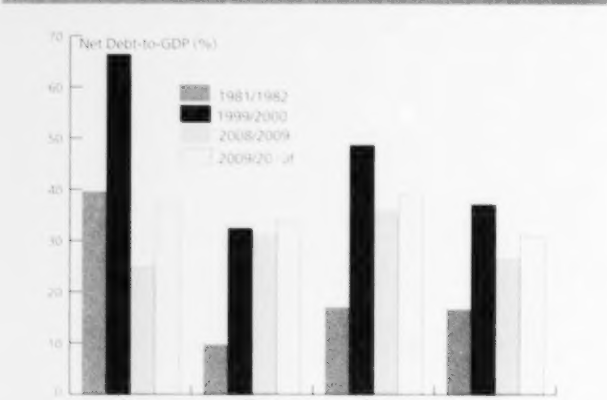
Over the last decade Prince Edward Island has had some of the largest annual deficits in Canada relative to the size of its economy. The province has recorded only four surpluses in the last twenty-five years and its debt-to-GDP ratio is currently the fourth-highest in Canada. A 13.5% increase in federal transfers in 2009/2010, relating to a temporary boost in infrastructure funding and the transfer of funding and responsibility for labour market agreements, helped shore up revenues this fiscal year. A gradual recovery in own-source revenues combined with a continuation of recent

Atlantic Provincial Deficits Smaller Than Previous Recessions



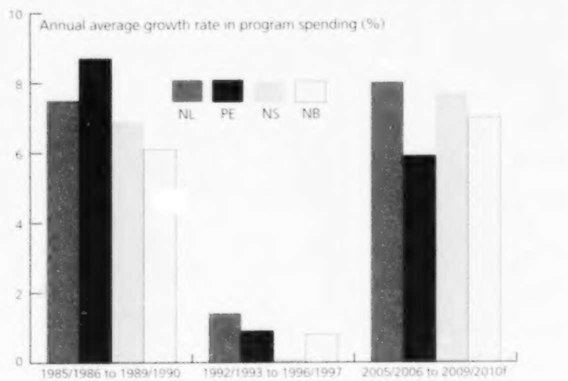
Source: Finance Canada Fiscal Reference Tables, Provincial Finance Departments, Statistics Canada

Debt-to-GDP Ratios on the Rise Again



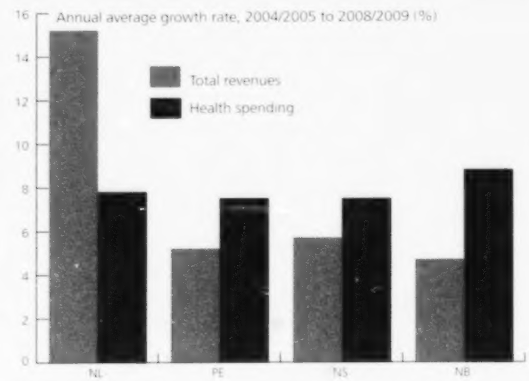
Source: Finance Canada Fiscal Reference Tables, Provincial Finance Departments, Statistics Canada

Long-Term Expenditure Control Required



Source: Finance Canada Fiscal Reference Tables, Provincial Finance Departments.

Health Care Spending Outpacing Revenues in the Maritime Provinces



Source: Statistics Canada.

spending growth could easily see the deficit swell to $100 million by 2014/2015. A moderation in the growth rate of federal transfers would cause this deficit to escalate even faster.

The Atlantic provinces need to anticipate the risk of lower growth paths for federal transfers, particularly when the current agreements on the Canada Health Transfer and the Canada Social Transfer expire in 2013/2014. Federal transfers currently account for between 36% and 44% of total revenues in the three Maritime provinces. This ratio has fallen to below 20% in Newfoundland and Labrador as rising resource revenues mean the province no longer receives Equalization payments.

Persistent or growing deficits pose significant risks. Rising debt implies higher debt charges and less money for government programs. Debt charges as a percentage of revenue ranged from 8% to 11% in the Atlantic provinces in 2008/2009. Even with no increase in debt, interest rates will rise over the next few years as the global recovery takes hold, pushing up debt servicing costs. Elevated debt-to-GDP ratios also run the risk of lower credit ratings, further increasing effective borrowing costs. One rating agency downgraded New Brunswick's credit rating in August 2009.

Slaying the Deficit

The Atlantic provinces need to establish credible, long-term and detailed plans to return to fiscal balance and to adjust both the level and long-term growth path of government spending to match projected revenues. Drastic measures to slay provincial deficits in 2010/2011 risk undermining Atlantic Canada's economic recovery, but postponing policy adjustments will increase the size of the fiscal challenge requiring more draconian measures later on. An Economic Advisory Panel advised the Nova Scotia government to erase its deficit by 2012/2013 through a combination of tax increases and significant spending restraint. The Nova Scotia government is currently considering a 2% increase in the HST as part of its fiscal plan. The potential for tapping non-tax revenue sources in the Atlantic region is limited. Gaming revenues, for example, have peaked (except in New Brunswick which will benefit from the opening of a casino this year) while user fees generally account for less than 5% of total revenues.

Measures to restrain spending need to be sustainable. In the mid-1990s, provincial governments did succeed in containing the growth rate of program spending, to below an average annual rate of 1% in the three Maritime provinces. However, in the last five years, program spending growth has accelerated to between 6% and 8%. Only in Newfoundland and Labrador have own-source revenues expanded faster than spending.

Governments will also need to address spending pressures in core areas such as health care. Health care accounts for about 35% of total program spending in Newfoundland and Labrador and Prince Edward Island and about 40-41% of program spending in Nova Scotia and New Brunswick. However, over the last five years spending on health has been growing at an annual average rate of 7.5% or faster in the Atlantic provinces. An aging population will place further upward pressure on health and senior care budgets in the coming years.

Report Card **is published four times per year by the Atlantic Provinces Economic Council (APEC) and is sponsored by The Bank of Nova Scotia[1]. Information on *Report Card* and/or on the Atlantic Provinces Economic Council is available from:**

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